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The Profits Of Doom

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by John Greenwald

MAR 18, 1990 9:00 PM PT

As ailing U.S. companies collapse beneath the debt they assumed in the Roaring Eighties, a new breed of vultures has begun to swoop down on the corporate carcasses. The predators include sharp-eyed lawyers, investment bankers and bargain hunters who have parlayed the business of profiting from failure into Wall Street's hottest growth industry. Ironically, many of the same financiers who loaded companies down with debt are now cashing in on the overleveraged firms' troubles. Not since merger madness first hit corporate America in the mid-'80s has so lucrative a financial field opened up so swiftly. Says Robert Miller, a Manhattan attorney who advises failing companies: "The buyout business of the 1980s has become the turnaround business of the 1990s." Concurs bankruptcy adviser Jay Alix: "To us, LBO means large bankruptcy opportunity."

The switch reflects the growing peril of runaway borrowing. Last year 68,112 U.S. firms filed for bankruptcy vs. 10,622 in 1981. And the failures are getting larger. The assets of bankrupt companies totaled $67 billion in 1989, up 52% from the previous year. The 1990 pace could be even quicker. Since January the Wall Street firm Drexel Burnham Lambert (assets: $3.6 billion) and , the U.S. retailing arm of Canada's Campeau Corp. ($9 billion) have sought protection from creditors. They joined such major companies as Eastern Air Lines and LTV Corp., the third largest U.S. steel company, which had earlier taken refuge in bankruptcy proceedings.

But companies do not have to file for Chapter 11 to lure the new vultures. “There are many shades of failure,” says Sanford Sigoloff, a turnaround specialist who runs the bankrupt U.S. operations of Australia-based Hooker Corp., which owns the B. Altman and Bonwit Teller department-store chains. Such troubled but solvent corporations as Wang Laboratories, the Lowell, Mass., computer maker that laid off more than 1,500 workers last year, have hired “workout” advisers to help pare down their debt. By pursuing a workout instead of bankruptcy, management can maintain control of the company and generally reorganize faster. “There’s more room to maneuver outside of court,” says Richard Feintuch, a partner in Wachtell, Lipton, a leading Wall Street law firm.

Turnaround experts can rake in hefty fees by representing ailing companies or disgruntled creditors — or sometimes both. Lawyers and accountants earned nearly $4 million for preparing Campeau’s 6,000-page bankruptcy petition in January, and currently share fees that total about $2 million a month for advising the company. The legal and financial specialists who guided Manville Corp. out of bankruptcy in 1988 received $100 million from the asbestos maker. “Every profession in the business of fixing and restructuring troubled companies is going through a sudden growth spurt,” says Christopher Beard, publisher of Turnarounds & Workouts, an industry newsletter.

The bust business has attracted some unlikely saviors. Shortly before it declared bankruptcy last month, Drexel Burnham Lambert beefed up a unit that advised distressed companies. The move was viewed with cynicism by some on Wall Street since Drexel, through its junk-bond financing of buyouts, was a prime contributor to today’s bankruptcy boom. Other improbable rescuers include First Boston, which advised Campeau to borrow more than $10 billion to buy Bloomingdale’s, Jordan Marsh and seven other U.S. store chains. Some critics attack Wall Street firms for profiting from both the debt buildup of the ’80s and the subsequent spate of failures. “There ought to be something unethical about cashing in on the way up and on the way down,” says novelist Michael Thomas (Hanover Place), a former investment banker. “It’s like a doctor who builds a trade infecting people and then purports to cure them. This would raise ethical questions anywhere but on Wall Street.”

In Washington Congress has begun to consider sweeping changes in U.S. bankruptcy laws that could make it harder for turnaround artists to profit from troubled companies. One call for reform came from James Queenan Jr., a U.S. bankruptcy judge for

Massachusetts, who termed the wave of 1980s buyouts “the greatest demonstration of greed that I have seen in my lifetime.” Queenan testified that tougher restrictions on bankrupt companies “would present a major deterrent to abuses” by discouraging firms from irresponsibly loading up on debt and then enjoying court protection.

Today’s turnaround boom is rooted not only in overleveraging but also in a 1978 overhaul of the bankruptcy laws that strengthened the hand of ailing companies in negotiations with their creditors. The changes permitted bankrupt firms to restructure their finances and return to business without struggling through pitched court battles over every asset. Explains David Post, executive director of the Turnaround Management Association, a North Carolina-based trade group: “1978 said that if you can achieve an agreement with a majority of your creditors, the court will allow you to reorganize” without satisfying all of them.

Among turnaround artists, the competition to advise the creditors of bankrupt companies has grown fiercer by the week. To gain the confidence of prospective clients, even the best-known advisers must often work for months without being formally hired. The day after Drexel declared bankruptcy in February, some of its major creditors sought help from Wilbur Ross, a senior managing director at Rothschild Inc., a top workout firm. Ross agreed to represent half a dozen large bondholders, who held a total of $100 million in Drexel notes, without a retainer in order to win their business. Says he: “We can’t run ads, so we market by being there and offering help when they need it.”

Even after they sign up clients, turnaround specialists must land a spot on court-appointed creditor committees before they can earn big payments. To boost the odds in their favor, specialists often bombard the creditors who head the committees with letters and phone calls as part of campaigns known as “beauty contests.” In the wake of the Campeau bankruptcy filing, 50 leading legal, accounting and investment firms have been battling for some 15 < seats on the all-important creditors’ panels. Says a disappointed attorney who lost the opportunity to earn at least $300,000 in monthly fees: “It’s a very political process.”

Many advisers who work the company side of the street offer a rich range of services to their corporate clients for fees that can reach $6,000 a day. The specialists take over a company’s debt-cleanup chores, including negotiations with banks and creditor

committees, leaving executives free to run their businesses. “Some people call us vultures,” says adviser Jay Alix, “but that’s unfair, because we provide a valuable service. Just as people with cancer go to a doctor, and people with a toothache go to a dentist, sick companies come to us. We’re debt doctors.”

On Wall Street, some firms have created funds that let small investors profit from improvements in the condition of ailing companies. Called “vulture,” “phoenix” or even “Lazarus” funds, such portfolios invest in troubled companies deemed likely to return to health. Other brokerages specialize in recommending bargain-price stocks and bonds of ailing companies to their clients. “You just have to do your homework,” says Michael Singer, the president of R.D. Smith, which advised its customers to buy Public Service of New Hampshire bonds in 1988 after the utility filed for bankruptcy. The price of the bonds has since climbed from 30 cents on the dollar to nearly full value as the company has reorganized.

Other investors seek to profit from failing companies by buying them and turning them around. Sam Zell, chairman of Chicago-based Itel Corp. (1989 revenues: $2 billion), is raising up to $1 billion for a fund that would acquire firms at fire-sale prices. Says he: “Anytime you have a period of excess, you’re going to have a period of distress that follows. Our sole purpose is to buy good companies with bad balance sheets. Our goal is to restructure their finances and come out the other end with a viable company.” Zell is hardly alone in his ambition. Texas investor Thomas Kelly II and several partners plan to launch a fund to invest up to $500 million in cash- starved companies. “This is not some brilliant concept that somebody just thought up,” Kelly says. “Everyone wants to do it.”

That includes cash-rich foreign corporations. In Dallas the Pizza Inn chain of 700 restaurants, which filed for bankruptcy last September, has had nibbles from Japanese and European investors. Says Harry Dixon, an Omaha-based attorney and chairman of the American Bankruptcy Institute, who represents Pizza Inn: “We are getting constant inquiries from some very substantial companies, including FORTUNE 500 firms that are looking for bargains. Anybody who’s got cash in today’s market is a major player.”

The game could remain hot for years if more overleveraged companies run into trouble. “There will be plenty of bankruptcies and workouts,” predicts Rothschild’s Ross, “because if we’re this busy now, what’s going to happen when the economy sours?” Indeed, in the

world of finance, the 1990s could prove to be the decade of the vulture.

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